Postal Regulatory Commission
Submitted 9/11/2009 1:10:20 PM
Filing ID: 64687

BEFORE THE POSTAL REGULATORY COMMISSION

WASHINGTON, D.C. 20268-0001

Consideration of Workshare Discount Methodologies

Docket No. RM2009-3

COMMENTS OF THE DIRECT MARKETING ASSOCIATION

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DATED: September 11, 2009

On July 10, 2009 the Postal Regulatory Commission ("PRC") issued ORDER NO. 243, ORDER ON FURTHER PROCEDURAL STEPS, in Docket No, RM 2009-3. As the PRC explained in this order:

> There are two issues that the Commission would like to explore further in the context of a public forum. The first is the issue of whether the users of single-piece First-Class Mail are entitled to special protection under the PAEA [Postal Accountability and Enhancement Act], and, if so, whether protection should take the form of:
>
> - Maintaining the traditional linkage of single-piece rates to the rates charged for Presorted First-Class Mail through a suitable benchmark;
> - Establishing a separate class of single-piece First-Class Mail subject to its own rate cap;
> - Adopting a regulation that would limit the difference allowed between single-piece and presorted First-Class Mail in terms of either average revenue per piece or percent contribution to institutional costs;
> - Relying on a qualitative or subjective standard of protection, such as the "just and reasonable" standard of section 3622(b)(8); or
> - Other suggested forms of protection. Order at 4.

DMA's comments focus on this first issue—the issue in this rule making which is of paramount importance to many DMA's members. As we explain, there is nothing in the Postal Accountability and Enhancement Act (PAEA) that mandates the special protection that Single-Piece First-Class Mail has traditionally received. However, the special protection that has been provided has been based upon the "just and reasonable" standard of 3622(b)(8). Beyond that "authority" for special treatment, linking Single-Piece and Presort Letter prices actually harms the Postal Service financially. As we show below, linking Single-Piece and Presort prices reduces the potential contribution of First-Class letters by $373 million below the potential contribution currently possible under the rate cap.

NOTHING IN THE ACT ENTITLES FIRST-CLASS SINGLE-PIECE MAIL TO THE SPECIAL PROTECTION IT HAS BEEN RECEIVING

Section 404(c) of Title 39 requires the Postal Service to maintain at least one class of letter mail "sealed against inspection. The rate for each such class shall be uniform throughout the United States, its territories and possessions." This provision is the only such preference accorded First-Class letter mail. There is no provision requiring the integer cent constraint, specific cost coverages or First-Class rate relationships. Congress has established specific rate relationships for nonprofit mail but not First-Class Mail.

Nothwithstanding that there is nothing in PAEA or the 1970 Postal Reorganization Act that required special protection for Single-Piece First-Class Mail, it is clear that it has been afforded special protection. For example, the PRC has noted:

> From a purely economic perspective, for rates to be non-discriminatory, the rates need to reflect an Efficient Component Pricing (ECP) approach or reflect equal percentage markups."[24] FY 2008 Annual Compliance Determination (ACD) at 62.

And the cited footnote goes on to state:

> The ECP approach can be characterized as "rate differences equal cost differences" which is non-discriminatory because rates differences are cost based. Similarly, equal cost coverages are nondiscriminatory because the proportionate differences in rates equal the proportionate differences in cost and are therefore cost based.

However, the cost difference for First-Class Single-Piece Letters and Presort Letters is much larger than the price difference (by subtraction, the FY 2008 ACD, Table VI-I, page 42 shows a difference in revenue per piece of 9.149 cents per piece but a cost difference of 13.949 cents per piece.) And the coverage on Single-Piece Letters is 170.9 percent while it is 301.5 percent on Presort Letters. (*ibid.*)

In part these cost, price, and markup disparities—all of which could be read as causing discriminatory rates according to the above cites—arise because the PRC measures the cost differences between Single-Piece Letters and Presort Letters from a BMM benchmark that is both theoretically and practically incorrect, as shown in the R2006-1 testimonies of John C. Panzar on behalf of Pitney Bowes (PB-T-1 at 35-39) and Elizabeth Bell for the National Association of Presort Mailers. (NAPM RT-1 at 2-6.)

HOWEVER, IF THE PRC DECIDES THAT SINGLE-PIECE FIRST-CLASS LETTERS ARE ENTITLED TO SPECIAL PROTECTION, A "JUST AND REASONABLE' STANDARD IS BEST

DMA believes that Single-Piece First-Class Mail is adequately protected by the just and reasonable standard of 3622(b)(8) and that the draconian protection of linking is unnecessary. The Postal Service's first two filings for Market Dominant Price Adjustments under PAEA, filings under which it believed that linking did not constrain its pricing decisions, support this position.

In R 2008-1, the first of these filings, Presort Letters and Cards received a price increase of 3.55 percent and Single-Piece Letters and Cards received an increase of 2.50 percent, or 1.05 percent less than Presort. (Filing at 13.) In R 2009-2, the second of these filings, the Postal Service reversed the recipient of the larger increase. Here, Presort Letters and Cards received a price increase of 3.080 percent and Single-Piece Letters and Cards received an increase of 4.616 percent, or 1.536 percent more than Presort. (Filing at 12) Thus, even without any of the protection conferred by linking, the Postal Service did not abuse its pricing flexibility by immediately "sticking it" to Single-Piece. In fact, over the two rate cycles, the percentage price increases for Presort and Single-Piece were about as equal as possible, given the integer constraint. DMA thus believes that the very actions of the Postal Service under PAEA demonstrate that a just and reasonable standard would provide any protection necessary.

We further note that establishing a separate class of single-piece First-Class subject to its own price cap may not be allowed pursuant to 3622 (d)(2)(A) of Title 39. Further, the integer constraint (which is not required by law) would make it more difficult for the Postal Service to

use its full cap authority if it decided on its own accord to apply equal price increases to the various product within First-Class Mail, which is within Postal Service authority.

Finally, the devil is in the details regarding adoption of "a regulation that would limit the difference allowed between single-piece and presorted First-Class Mail in terms of either average revenue per piece or percent contribution to institutional costs." Thus, we suggest that "just and reasonable" is a much better standard.

FIRST-CLASS LETTER CONTRIBUTION UNDER THE LINKAGE CONSTRAINT IS SUBSTANTIALLY BELOW THE CONTRIBUTION THAT COULD BE PROVIDED WITH OPTIMIZED RATES UNDER THE EXISTING RATE CAP

The Appendix to these comments provides an analysis of prices for First-Class Single Piece and Presort letters that would maximize their contribution. The analysis uses the most recent own-price, workshare discount, and cross-price elasticities provided by the Postal Service, along with volumes, average prices, and average attributable costs for Fiscal Year 2008. With respect to the average prices during FY 2008, the analysis shows that contribution could have been increased by $373 million with an adjustment in First-Class letter prices to increase Single-Piece average rates by $0.060 and decrease Presort average rates by $0.042.

Although the analysis shows that contribution would be maximized with a change for First-Class letters that increases Single-Piece average rates by $0.060 and decreases Presort average rates by $0.042, we are not advocating that USPS choose rates solely by their level of expected contribution without considering other factors. Table 1 shows the changes in contribution resulting with other possible adjustments to Single Piece and Presort average prices near current prices or near the prices that maximize contribution. The table shows that a substantial portion of the $373 million increase in contribution that is achieved at the maximum can be achieved with more modest adjustments from current prices. The table also shows the substantial losses in contribution that result from even small reductions below the current price for Single Piece letters.

Table 1: Contribution Changes from Changes in First Class Letter Prices

Single Piece Rate Change	Presort Rate Change	Contribution Change
-$0.020	+$0.014	-$399 million
-$0.010	+$0.007	-$171 million
+$0.010	-$0.007	+$129 million
+$0.020	-$0.014	+$224 million
+$0.030	-$0.021	+$293 million
+$0.040	-$0.028	+$339 million
+$0.050	-$0.035	+$365 million
+$0.060	**-$0.042**	**+$373 million**
+$0.070	-$0.048	+$365 million

The results of the analysis in the Appendix differ dramatically from those obtained by Robert Mitchell in his recent comments in this docket filed on August 24, 2009. Although there are a number of superficial differences between our approach and Mitchell's, the primary reason for the difference between his results and ours is his decision to force the volume shift caused by the workshare discount to be equal for Single-Piece and Presort so that they cancel each other out. As explained in the Appendix, Mitchell errs in doing this because the estimates of the elasticities that he uses are derived from a set of econometric demand equations that were estimated without imposing such an equality constraint on the volume responses to the workshare discount. As a result, Mitchell is using incorrect values for all of his elasticity estimates – including the own-price elasticities – because he is applying them in a model that imposes an equality constraint in the workshare discount responses. If Mitchell wants to take his approach of forcing equality in the response to the workshare discount, he must re-estimate the demand equations with such equality enforced there as well in order to derive a correct set of elasticities. The Appendix demonstrates that the imposition of this constraint is the decisive factor in producing Mitchell's estimate; when the same constraint is imposed on our model, the maximum increase in contribution from abandoning the linkage constraint is reduced from $373 million to $34 million. The Appendix further shows that a second minor assumption by Mitchell further reduces the maximum increase in contribution to $3 million.

Contrary to Mitchell's conclusion based on the imposition of an incorrect assumption, a correct analysis of contribution-maximizing rates for First Class letters shows that they are likely to result in a substantial increase in contribution.

APPENDIX

The attached Excel spreadsheet provides an analysis of prices for First-Class Single-Piece and Presort letters that would maximize their contribution. The analysis uses the most recent own-price, workshare discount, and cross-price elasticities provided by the Postal Service, along with volumes, average prices, and average attributable costs for Fiscal Year 2008.

The three worksheets contained in the spreadsheet calculate the increase in contribution resulting from different rates for Single-Piece and Presort letters. Rather than calculating the maximum contribution analytically, the maximum is calculated "by hand" – substituting different values for the prices until a maximum is obtained. This is straightforward to do because only one of the two prices – for Single-Piece and Presort – can be independently set if we assume the price cap continues to apply since the price cap will determine the second price once the first one has been set. For each of the worksheets, the formulas are set up to determine Presort price once the Single- Piece price is set. As a result, the maximum is obtained by varying the price of Single- Piece letters (yellow box) until the total increase in contribution (purple box) is maximized.

In addition to using the own-price elasticities and workshare discount elasticities for both Single-Piece and Presort letters, the worksheets also show the effect of the Presort price on the volume and contribution of Standard Regular letters, since the Postal Service econometric demand equations have found this to be a significant effect. For each pair of possible new prices, the new prices are combined with the elasticities to derive the expected volume change, holding everything else equal.

The first worksheet ("Max Contribution") provides the basic analysis. For the values that we're using (the most recent elasticity estimates, along with volumes, prices, and costs for FY 2008), the maximum is reached when the average Single-Piece price is increased by $0.060 (from $0.428 to $0.488), which decreases the Presort price by $0.042 (from $0.337 to $0.295) through the price cap. These price changes increase Presort volume and decrease Single-Piece

and Standard Regular volume. The net result of the changes and the volume shifts is to increase contribution by $373 million.

The results of our model are substantially different from those found by Mitchell in comments filed in this docket on August 24, 2009. Mitchell concludes that contribution-maximizing prices for Single-Piece and Presort letters would produce prices that are very close to current prices and an increase in contribution of only $1.6 million (Mitchell at 12).

There are a number of superficial differences between Mitchell's analysis and ours. First is the fact that Mitchell finds the maximum analytically rather than using our simple spreadsheet approach; however, if both methods are implemented correctly and incorporate the same values and assumptions they should produce the same result. Second, Mitchell also calculates the increase from 2008 prices for a specified increase in the price cap whereas we calculate the change from 2008 with no price cap increase; again, however, this will not cause a significant difference in the result. Third, Mitchell omits the impact of Presort letter price changes on contribution that occurs through changes in Standard Regular letter volume, as indicated by the Postal Service econometric estimates of the cross-price elasticity for Standard Regular letter volume with respect to the Presort letter price. However, our calculation of the maximum indicates that this indirect effect is relatively small and so its omission should not be critical.

The primary reason for the difference between Mitchell's results and ours appears to be his decision to force the volume shift caused by the workshare discount to be equal for Single-Piece and Presort so that they cancel each other out. Mitchell discusses his decision to use equal values in his comments (Mitchell at 7). Intuitively, Mitchell's approach sounds reasonable -- it seems like the volume shift from/to Single- Piece caused by a change in the workshare discount should be equal to the volume shift to/from Presort caused by that same change in the workshare discount. However, the problem with imposing this assumption as Mitchell does is that it overlooks the fact that the estimates of the elasticities come from a set of econometric demand equations that were estimated without imposing any equality constraint on the workshare discount elasticities. If the equations had been estimated with the workshare discount elasticities constrained to be equal, then the other parameter values in the regression -- specifically the own-

price elasticities – would have been different. So Mitchell is effectively using the wrong own-price elasticities if he wants to impose equality in the response to the workshare discount. If Mitchell wants to take his approach of forcing equality in the response to the workshare discount, he must go back to re-estimate the demand equations with equality enforced there as well so that he has appropriate own-price elasticities to use under that constraint. Without taking that step, his values for the elasticities don't fit the historical record for the types of volume changes that have occurred in response to changes in prices.

To demonstrate that Mitchell's forced equality in the workshare discount responses is sufficient to cause the primary difference with our results, the second worksheet ("Max Contribution + Mitchell 1") in the attached spreadsheet implements this change. With this constraint imposed, the price differences are significantly moderated -- with the contribution-maximizing Single-Piece price increasing by only $0.022 (from $0.428 to $0.451) and the Presort price decreasing by only $0.015 (from $0.337 to $0.321). Furthermore, the increase in contribution that results at the maximum is only $34 million instead of $373 million. Effectively, this one error of imposing equality in the workshare discount responses incorrectly eliminates most of the increase in contribution that the analysis should show.

A second significant change that Mitchell introduces is his use of the BMM cost for the Single-Piece volume that switches to Presort, rather than the average attributable cost for Single-Piece that we use (Mitchell Appendix at 5). To show the effect of this change, our third worksheet ("Max Contribution + Mitchell 1+2") adds this second change to our basic analysis, on top of the enforced equality in responses to the workshare discount. For simplicity, our spreadsheet applies the BMM cost to all Single- Piece volume rather than only to the portion of volume that switches to Presort -- this overstates the total contribution figures but does not overstate the increase in contribution because it overstates Single-Piece contribution for both the old and new volumes by the same amount. In this version, with both of Mitchell's alternate assumptions, the contribution-maximizing prices barely change -- decreasing by $0.006 (from $0.428 to $0.422) for Single Piece and increasing by $0.004 (from $0.337 to $0.341) for Presort -- and contribution increases by only $3 million. This finding of effectively no change from current prices or contribution is essentially the result Mitchell obtains.